RESERVE BANK OF NEW ZEALAND

Feedback on October 2010 consultation on covered bonds

Introduction

1. In October 2010 the Reserve Bank of New Zealand ("Reserve Bank") released the consultation document: "Covered bonds". The Reserve Bank received twelve formal submissions on the draft proposals. This note provides a summary of the main substantive issues raised in the submissions, and outlines the Reserve Bank's response on those areas on which final decisions have been taken.
2. The note is divided into five sections. The first and second sections discuss the general implications of the development of covered bonds in New Zealand and the proposal for a regulatory limit on issuance, respectively. These sections include the Reserve Bank's response to the issues raised in submissions.
3. The third section then focuses on the possible introduction of legislation to support the issuance of covered bonds, with the fourth section dealing with issues surrounding the appropriate structure of the bonds and the wider regulatory framework. The final section covers issues relating to capital adequacy and disclosure. These sections provide a summary of responses only. Further detail on the Reserve Bank's response to these issues will be published alongside its final decisions on these matters.

Section 1: Development of covered bonds in New Zealand

4. Part 2 of the consultation document provided a high-level background discussion of covered bonds and asked respondents for views on the potential savings on funding costs that might be achievable through the issuance of the bonds. Part 3 then provided a more focused discussion on the implications of allowing institutions in New Zealand to issue covered bonds and asked respondents to identify any overriding factors that should preclude them from accessing this form of funding.

Summary of responses

5. With regard to potential savings from issuance of covered bonds, the majority of responses argued that savings were likely, based on evidence from both overseas and initial issuances in New Zealand. The responses noted various factors that would impact on the scale of any savings that could be achieved. These included the structure of the regulatory framework, sovereign risk, issuer ratings, the structure of the bond, the size of the issuer, and the volume and frequency of the issuance.
6. On the subject of overriding factors that should preclude institutions in New Zealand from issuing covered bonds, the majority of respondents agreed with the

Reserve Bank's initial assessment, namely that there were some negative implications associated with covered bonds, but that these would be outweighed by the positives provided issuance levels were reasonably conservative.

7. One respondent noted that the existing statutory management provisions make it difficult for a New Zealand-owned bank to create a covered bond structure without a formal regulatory framework in place, potentially resulting in a competitive disadvantage.

Reserve Bank response

8. In light of the responses received, the Reserve Bank is satisfied that there is no strong case for it to seek to introduce new regulations to preclude New Zealand institutions from issuing covered bonds. It will be continuing to work on the development of an appropriate regulatory framework to ensure that the benefits of covered bond issuance are maximised where possible. This work will also seek to address any concerns regarding competitive disadvantages between different institutions.

Section 2: Regulatory limits

9. Part 4 of the consultation document discussed the likely volumes of covered bonds that institutions might seek to issue, and addressed the need for regulatory limits to constrain the issuance of covered bonds and other instruments.

Summary of responses

Possible issuance levels

10. The consultation document asked respondents to provide views on the level of covered bond and residential mortgage backed-backed securities (RMBS) issuance that a New Zealand institution might be expected to adopt if there were no regulatory requirements to constrain issuance.

11. A number of responses indicated that the primary focus would be on maintaining existing unsecured ratings, with issuance levels targeted to minimise the risk of a downgrade. Respondents offered views on the level at which ratings might come under pressure:

    - one response argued that an institution could issue up to 20 percent of assets in covered bond format without any impact on unsecured ratings;
    - one response noted that the rating of the issuing bank may be at risk if asset encumbrance approached 10 percent of assets, but noted that it would be heavily dependent on the characteristics of the institution and the assets encumbered; and
    - one response noted that rating agencies refer to a rule of thumb that total encumbrance exceeding 20 percent of total assets may result in a deterioration of the financial strength of the institution, but argued that the level at which any specific institution might be affected could range from 10-40 percent, subject to particular characteristics.

12. The responses identified a number of factors that might be expected to impact on the quantum of assets that an institution might be willing to encumber. These included:
    - the characteristics of the institution;
    - the characteristics of the assets being encumbered;
    - the level of over-collateralisation required;
    - the impact on the bank's asset mix;
    - the type of RMBS/covered bond structure being adopted; and
    - the proportion the RMBS/covered bonds funding represents of total wholesale funding.

Introduction of regulatory limits

13. The consultation document asked whether it would be appropriate to introduce a regulatory limit on covered bond issuance. The majority of responses accepted that a regulatory limit would be appropriate.
14. One response specifically noted that a limit was relevant due to the requirement to over-collateralise and the dynamic nature of the assets encumbered (not features of RMBS), while another argued in favour of a limit because investors would have a charge over higher quality assets. One respondent noted that a limit would provide greater certainty for issues and investors, but argued that a flexible case-by-case approach might be more appropriate.
15. One response argued that a regulatory limit was unnecessary as issuers would self-regulate due to the focus on maintaining their unsecured rating. As the issuer's rating affects the rating that a covered bond issue can achieve, it was argued that this will constrain the bank's capacity to issue.

Appropriate level for regulatory limits

16. The consultation document proposed an initial limit for maximum covered bond issuance of 10 percent of total assets. The majority of responses considered 10 percent to be appropriate as an initial limit. A couple of responses argued that there should be scope for issuance beyond this level subject to a case-by-case assessment, whilst some respondents argued that a higher limit would be appropriate in the longer-term.
17. A number of respondents commented on the proposal to base the limit on the value of assets encumbered, arguing that the limit should be set on the notional face-value of the bonds outstanding instead. In particular, the following arguments were raised:
    - a limit based on encumbered assets would make monitoring, planning and management more difficult as the cover pool of assets is dynamic;
    - the level of over-collateralisation may change as a result of a ratings downgrade, and institutions should have the flexibility to determine whether they wish to transfer more assets to protect the covered bond rating; and

- the level of over-collateralisation may change as a result of the ratings agencies adopting a new approach to rating covered bonds.

18. One response argued that a broader limit of 20 percent should be set against all encumbered assets, with flexibility for institutions to determine the best combination of programmes within that limit. It was argued that this would provide opportunities for more regular issuance which is an attribute sought by covered bond investors.

19. One response argued that the 10 percent limit should apply to covered bonds and asset sales to parent, although noting that there was some argument for a sliding scale with banks with higher levels of non-performing loans being subject to a lower limit.

Limiting other forms of asset encumbrance

20. Finally, the consultation asked whether there should be a limit on some, or all, forms of RMBS. Most responses did not consider that such an approach would be appropriate. Specific comments included that:

    - no limits were applied to RMBS/asset-backed security (ABS) issuance in other jurisdictions;
    - limits would be unnecessary provided there is no requirement to top up/replace the securities, or provide other credit support;
    - RMBS is not used as a funding vehicle, but as a beneficial source of reserve liquidity;
    - banks will self-impose limits;
    - existing Reserve Bank repo rules on RMBS limit the amount that banks hold; and
    - limits could be problematic in the event that there was a repeat of systemic liquidity constraints, as experienced during the global financial crisis.

21. One respondent argued for a limit on the total amount of encumbered assets, but did not consider that it would be appropriate to apply a limit to RMBS specifically. One respondent considered that some form of limit may be appropriate, while another respondent argued that it may be appropriate to require that assets encumbered were representative of that class of assets held by the financial institution.

Reserve Bank response

22. The Reserve Bank notes that the likely levels of issuance, and the key factors identified by respondents as drivers of issuance, broadly align with the expectations it formed through discussions with ratings agencies, as outlined in Part 4 of the consultation document.

23. Given the broad agreement from respondents that a regulatory limit would be appropriate, at least in the short-term, the Reserve Bank intends to adopt the approach proposed in the consultation document. As such, a regulatory limit constraining the transfer of assets into covered bonds to 10 percent of total assets will be introduced.

24. The primary concern raised by respondents surrounded the basis of this limit, with a number of respondents arguing that it should be based on the notional face value of the bond, rather than the volume of assets encumbered in the covered bond structure. The Reserve Bank does not consider that a limit based on the face value of the bond would be appropriate as it does not address the primary prudential concern arising from the issuance of covered bonds, namely the encumbrance of assets. The Reserve Bank recognises that this approach places the onus on institutions to set issuance levels that include sufficient headroom to reflect the level of risk of downgrade that is inherent in their operations. As a result, stronger institutions may feel more comfortable issuing a higher volume of covered bonds. The Reserve Bank considers that this outcome is more appropriate than weaker institutions encumbering a higher proportion of assets to support the same level of issuance as more robust entities.

25. Given that a 10 percent limit on encumbered assets represents a more conservative position than many respondents assumed when they supported an initial 10 percent limit, the Reserve Bank will be monitoring developments in the market, and confirms its intention to review the appropriateness of this constraint within two years, as set out in the consultation document. This review will consider both the level of the constraint, and the merits of adopting a more case-by-case, or sliding scale, approach to reflect the specific characteristics of the institution.

26. The Reserve Bank does not intend to introduce a regulatory limit on RMBS at this stage. It will revisit this issue should the use of RMBS by New Zealand banks change materially in the future.

Section 3: Legislative framework

27. Part 5 of the consultation document discussed the advantages of legislatively-backed covered bonds, and proposed registration and a legislative safe-harbour as options for ensuring bankruptcy-remoteness.

Summary of responses

Benefits of legislative support

28. The consultation document outlined a number of factors which the Reserve Bank considered would benefit from legislative support, and asked whether legislative backing would generate material benefits for the New Zealand financial system.

29. The majority of responses indicated that legislative support would be beneficial, leading to better pricing and more efficient use of collateral by:

    - widening the range of potential investors (one respondent indicated the investor base could increase by 20 percent);
    - lengthening lending profiles;
    - removing ambiguity, particularly in light of statutory management provisions;
    - increasing certainty and transparency, such as when legislation was introduced for netting agreements in 1999;

- increasing investors' comfort with covered bonds issued by New Zealand banks;
- reducing transaction costs; and
- reducing the level of over-collateralisation required.

30. One response noted that legislative frameworks are not necessarily superior to contractual arrangements for ensuring the segregation of assets, and another observed that for benefits to be obtained from legislation, the legislation needs to have sufficient substance and detail for investors to feel it adds to the covered bond.

31. A number of responses identified statutory management as a key issue to be addressed by any legislation. First, some respondents were concerned that, if a bank is placed into statutory management, the special purpose vehicle (SPV) would be included in the statutory management as an "associated person" of the bank. The covered bond therefore needs to be structured to avoid this outcome. Currently banks are using entities controlled by an overseas parent to manage the SPV, so the SPV is less likely to be considered an "associated person". Some respondents argued that creating such an artificial structure is inefficient, and also puts New Zealand-owned banks at a competitive disadvantage. Respondents suggested that the regulatory framework should permit the bank to manage the SPV, provided that in all other respects the SPV is bankruptcy remote from the bank.

32. Second, some respondents were also concerned that the moratoriums that are imposed when a bank is placed in statutory management – banning any person other than the statutory manager from dealing with the bank's assets or acting as an agent of the bank - may stop the SPV from obtaining legal title to the cover assets. When the mortgage assets are sold to the cover pool, they are generally assigned in equity and held on trust for the SPV by the bank, with legal title to be transferred to the SPV upon the bank's default. Respondents suggested that legislation should clarify the effect of the moratorium on the transfer to the SPV, so investors have certainty as to the effect of statutory management of the bank on the cover pool.

Registration or 'safe harbour'

33. The consultation document proposed legislative protection for the cover pool from the insolvency or statutory management of the bank, either where the covered bond programme was registered with the Reserve Bank, or where the covered bond programme met certain criteria – i.e. a 'safe harbour' approach. The document asked whether a 'safe harbour' would provide investors with sufficient certainty.

34. The responses indicated that the safe harbour approach is preferable to the status quo, and is a good first step as long as the criteria sufficiently address investors' concerns. One respondent considered the safe harbour approach to be preferable to registration of covered bond programmes.

35. However, respondents generally viewed registration of covered bond programmes as superior to the safe harbour approach. There were concerns that the safe harbour option may create uncertainty at the margin, whereas registration would be a simple step providing a clear reference point for investors.

Section 4: Covered bond structures

36. Part 5 of the consultation document also discussed the structure of covered bond programmes, and the wider regulatory framework, including supervision by the Reserve Bank.

Summary of responses

SPV model

37. The consultation document asked whether it would be appropriate to restrict the structure of New Zealand covered bond programmes to the SPV model, where cover assets are transferred from the issuer to a separate legal entity.
38. Responses were generally supportive of this, noting that it was important to have a consistent, well-understood method of asset segregation, and that the SPV model is the most well-used and understood method. Furthermore, in the absence of a legislative framework, existing issues by New Zealand banks have been developed using this model, and respondents considered that this would continue.
39. Some respondents were concerned that the SPV model is not the most efficient method of segregation, as it is complicated to establish and maintain. Some considered that legislation should support the use of an integrated structure as well, so that issuers could choose the most efficient option for their circumstances. However, one respondent noted that supporting the integrated or "ring-fencing" approach would require substantial legislative change, with a corresponding risk of unintended consequences.
40. Two respondents highlight potential tax issues arising from asset transfers to the SPV, noting the tax-neutrality of the integrated model. These respondents consider that recently-enacted provisions treating the SPV as part of the bank for tax purposes under certain circumstances need to be amended to clarify the tax implications outside those circumstances.

'New Zealand covered bonds'

41. The consultation document mooted the idea of industry developing a single defined structure for a New Zealand registered covered bond, and asked whether this would be beneficial.
42. Respondents noted that the structures already adopted are broadly similar, and a consistent approach would help support further development. Consistency would also aid marketability and investor recognition of the product, considered particularly important given the size of the New Zealand covered bond market, and distance from investors.
43. However, respondents were concerned that any single structure must not specify all aspects of the structure, but be sufficiently flexible to accommodate existing covered bond programmes, and to allow for development and tailoring to suit issuers' individual circumstances. One respondent suggested that a flexible, consistent structure could be best achieved through guidance, rather than through a formal framework.

Asset eligibility

44. The consultation document proposed the Reserve Bank's Domestic Markets' operations asset eligibility criteria as initial minimum eligibility criteria for cover pool assets. Two respondents argued that the constraints imposed by the market would be sufficient to determine asset quality, but the majority supported these as initial criteria, provided they were updated as the market developed.

45. Respondents' main concern was the criterion that the loan to value ratio for each individual mortgage must not exceed 80 percent, in particular:

    - a loan to value ratio of less than 80 percent makes the encumbered assets less representative of the bank;
    - a loan to value ratio of less than 80 percent reduces the quality of the assets remaining;
    - such a loan to value ratio increases the risk of inadvertent breach by the issuer; and
    - the measurement of the loan to value ratio is on the basis of customer's total lending, rather than individual loans transferred to the cover pool.

46. Respondents indicated that having no limit on the loan to value ratio, but not giving credit in the asset coverage test to the part of the loan exceeding a loan to value ratio of 80 percent, would be more efficient. This option would give a bank more flexibility as to the quality of the assets remaining on its balance sheet.

47. One respondent also noted that minimum eligibility criteria would necessitate separate programmes for domestic and offshore covered bonds in order to differentiate between the cover pools.

Public supervision

48. In the consultation document, the Reserve Bank said it did not intend to provide detailed, on-going supervision. Overall, respondents, while noting that supervision provides a degree of comfort for investors, did not think this would have negative consequences for New Zealand covered bonds due to the monitoring provided by third parties in SPV programmes.

Refinancing risk

49. The consultation document suggested prescribing arrangements to support the ongoing servicing of a covered bond in the event of issuer default. Responses were mixed as to whether prescriptive arrangements should be introduced to help mitigate refinancing risk.

50. Two respondents were of the view that such intrusion would either be unnecessary, as most covered bonds will be issued in larger off-shore markets, minimising refinancing risk, or would be ineffective at addressing the risk.

51. Others thought a flexible framework would be worthwhile, as it would provide more certainty, and have a positive impact on investors' and rating agencies' assessments of the expected continuity of covered bonds payments upon default by the bank.

52. A number of respondents advocated repo-eligibility with the Reserve Bank, including for non-NZD denominated covered bonds issued by New Zealand

banks, as a solution. This was on the basis that repo-eligibility would provide increased certainty and improved marketability, as well as comfort that the true value of the cover pool would be realised. It was suggested by one respondent that a lower haircut rate may need to be applied than is currently applied to RMBS.

Section 5: Capital adequacy and disclosure

53. Part 6 of the consultation document considered capital adequacy rules and disclosure requirements for banks issuing covered bonds.

Summary of responses

Assessing capital adequacy

54. The consultation paper discussed additional capital requirements for banks that issue covered bonds, and asked whether capital adequacy should be assessed on a consolidated basis.
55. The majority of respondents were of the view that no additional capital requirements should apply, and that capital adequacy should be assessed on a consolidated basis. This was mainly due to the conservative limits on issuance posed by the Reserve Bank. However, one respondent was of the opinion that, regardless of limits, capital adequacy should be assessed and reported on both a consolidated and non-consolidated (i.e. without covered bonds) basis.
56. One response noted that the increased risks posed by covered bonds supports banks holding higher levels of regulatory capital. However, it was observed that any changes may need to be delayed until reviews of international capital standards are resolved.

Disclosure

57. Two respondents also commented on disclosure requirements for banks that issue covered bonds. In particular, the following points were made:
    - a bank's utilisation of covered bonds programmes should be disclosed.
    - covered bond issuance should be reported as a separate line item in the liability section of the balance sheet.
    - there should be regular and transparent disclosure of detailed data on both the issued covered bonds and the securing cover assets.
    - a separate note to the financial statements should provide details of the amount of assets used to support that covered bonds programme.
    - details should be provided by issuers as to cover pool composition, asset performance, interest rate, and currency and maturity mismatches between cover pool and covered bonds.

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